LAW SUMMARY
NONRESIDENT or PART-YEAR RESIDENT TAX LIABILITY
2002 and SUBSEQUENT YEARS

California law provides the specific method to be used to determine the tax liability of a nonresident or part-year resident taxpayer.

1. California law.

California Revenue and Taxation (Rev. & Tax.) Code section 17041, subdivision (b), provides that for each taxable year there shall be imposed upon the taxable income of every nonresident or part-year resident a tax on the income received from sources in California.

California's method of computing the tax liability of a nonresident or part-year resident taxpayer does not impose a tax on the nonresident or part-year resident taxpayer's income from sources outside of California (non-California source income). (See *Appeal of Dennis L. Boone*, 93-SBE-015, October 28, 1993.)

Hereinafter, all references to "taxpayer" means "nonresident or part-year resident taxpayer."

2. Calculation of tax.

For taxable years beginning on or after January 1, 2002, the method of computing a nonresident or part-year resident taxpayer's California tax liability uses the following nine steps:

Step 1: Determine taxpayer's total adjusted gross income (AGI) from all sources, as if the taxpayer was a California resident for the entire year. Total AGI includes income from sources within California and outside California including foreign earned income. Military income of a service member not domiciled in California is not included. See Section 4 below.

Step 2: Compute taxpayer's total taxable income by subtracting itemized deductions or the standard deduction (in the amount allowed as if the taxpayer had been a resident of California for the entire year) from his or her total AGI and determine taxpayer's tax on his or her total taxable income, usually from the Tax Tables or the Tax Rate Schedule.

Step 3: Calculate taxpayer's California tax rate by dividing the tax computed on the total taxable income by the total taxable income.

Step 4: Next, determine taxpayer's California AGI. This is any income from a source within California and income from non-California sources while taxpayer was a resident of California.

Step 5: Calculate taxpayer's itemized deductions (ID), as if he or she was a California resident. Multiply the larger of the ID or the applicable standard deduction (SD) by the ratio of California AGI (Step 4) to the total AGI (Step 1).

Larger of ID X California AGI (Step 4) = California ID
or the SD Total AGI (Step 1) or SD

Step 6: Calculate taxpayer's California taxable income (TI) by subtracting California itemized deductions (Step 5) from California AGI (step 4).

Step 7: Calculate taxpayer's California tax by multiplying his or her California taxable income (Step 6) by the California tax rate (Step 3).

Step 8: Compute taxpayer's California prorated exemption credits by multiplying total exemption credits by a ratio of the California taxable income (Step 6) to the total taxable income (Step 2).

Exemption X California TI (Step 6) = California
Credits Total TI (Step 2) Prorated Credit

Step 9: Finally, compute taxpayer's California tax after credits by subtracting the prorated exemption credits from the tax before credits.

3. The California method does not tax non-California source income.

The State Board of Equalization (Board) has consistently held that the use of the California method of computing a nonresident or part-year resident taxpayer' s tax is not the same as a tax on non-California source income.

The Board considered this issue in the *Appeal of Louis N. Million*, 87-SBE-036, May 7, 1987, where the taxpayer argued that he had only lived in California two or three months and that California was taxing both his California and non-California income. The Board held that the taxpayer had misconstrued the action of the Franchise Tax Board (FTB). The Board stated that under the law, the FTB was not taxing the taxpayer's non-California source income, but had merely used the taxpayer's total income from all sources to determine

the rate of tax and then used the applicable ratio (or percentage) to determine the California tax. (Also see *Appeal of Dennis L. Boone*, 93-SBE-015, October 28, 1993.)

Consequently, the FTB's use of the taxpayer's California and non-California source income to calculate the rate of tax did not result in a an assessment of tax on income from sources outside of California.

4. Military income and the California method.

Section 17140.5 of the Rev. & Tax. Code (added by Stats. 2004, Ch. 388, sec. 2) makes California law compatible with the Servicemembers Civil Relief Act as amended in 2003. Subdivision (d) specifically precludes the inclusion of compensation for military services from the calculation of (1) gross income of the servicemember or the spouse of the servicemember; (2) "entire taxable income" for purposes of computing tax; and from (3) "alternative minimum taxable income" for computing tax. (Rev. & Tax. Code section 17140.5(d)(1).)

The exclusion of military income provisions of section 17140.5 only apply to:

(1) Servicemembers not domiciled in California; and
(2) Any taxable year open as of December 19, 2003.

Prior to the enactment of Rev. & Tax. Code section 17140.5, the Board held that Rev. & Tax. Code section 17041 was the "precise method" to be used to calculate the taxpayer's California tax liability, including the use of military income of nonresident servicemembers in determining the rate of income tax to be levied on the income earned in California. (*Appeal of Dennis L. Boone*, 93-SBE-015, October 28, 1993.)

Although section 17041 remains the precise method of calculating a nonresident's or part-year resident's tax, that calculation specifically excludes the use of nonresident military income if the taxable year was open as of December 19, 2003.

5. It does not violate the Constitution for California to use income from outside of California to determine a taxpayer's California tax liability.

It has long been an established rule that states may use nontaxable out-of-state assets as the measure of the state tax imposed. (See *Great Atlantic & Pacific Tea Co. v. Grosjean* (1937) 301 U.S. 412 [81 L.Ed. 1193]; *Maxwell v. Bugbee* (1919) 250 U.S. 525 [63 L.Ed. 1124].) Therefore, use of income from outside of the state to calculate the rate of tax on a taxpayer's California income is not unconstitutional.

6. It is not unfair to use the nonresident or part-year resident's non-California source income to determine their tax rate, because California uses a progressive rate system.

California's progressive rate structure is based on the concept of "ability to pay." Individuals with higher income pay tax at a higher rate than low-income individuals. The fundamental fairness of such a rate structure was explained in *Brady v. New York* (1992) 80 N.Y.2d 596, 605 [607 N.E.2d 1060], certiorari denied (1993) 509 U.S. 905 [125 L.Ed.2d 692; 113 S.Ct. 2998]. The Court reasoned that similarly situated taxpayers were those with the same total income. For example, a nonresident earning $20,000 in New York, but with total income of $100,000, should be taxed at the same tax rate as a resident with an income of $100,000. In effect, the $20,000 will be taxed using a higher tax rate. In *Brady*, not using the taxpayer's total income to determine his rate of tax would have unfairly benefited him when compared with other New York taxpayers.

The *Brady* Court concluded that the taxpayer's real quarrel was with the graduated tax. A graduated or progressive taxation system apportions the tax burden based on ability to pay. Because higher income taxpayers can pay more, they are therefore taxed at a higher rate than lower income taxpayers. (Also, see *United States v. State of Kansas* (10th Cir. 1987) 810 F.2d 935, affirming (D.Kan. 1984) 580 F.Supp. 512, 515; *Appeal of Dennis L. Boone*, 93-SBE-015, October 28, 1993.)

7**. Filing Status: Generally, a husband and wife must use the same filing status on their California return as they used on their federal return.**

With limited exceptions, an individual is required to use the same filing status on his or her state return as was used on the federal return filed for the same year. (Rev. & Tax. Code section 18521(a)(1).)

Similarly, a husband and wife generally may not change their filing status to married filing separate after a joint return has been filed. (Rev. & Tax. Code section 18521(d).)

These general rules apply to all taxpayers unless they qualify for one of the exceptions listed in Sections 8 and 9 of this law summary. (Rev. & Tax. Code section 18521(c).)

8. Exception: If one spouse is an active member of the military.

Even though a husband and wife file a joint federal return, they may file separate California returns if one spouse is an active member of the military during the taxable year. (Rev. & Tax. Code section 18521(c)(1).)

The instruction pamphlets for California forms 540, 540A and 540NR clearly state that, if during the taxable year either spouse was an active member of the United States military, the couple may file either separate returns or a joint return. (Rev. & Tax. Code section 18521(c)(1).)

If the couple elects to file a joint return and either spouse was a nonresident or part-year resident during the taxable year, the couple must use the form 540NR, California Nonresident or Part-year Resident Income Tax Return.

9. Exception: If one spouse was a nonresident for the entire year and had no California source income. (Rev. & Tax. Code section 18521(c)(2).)

Even if husband and wife filed a joint federal return, they may file separate California returns if one spouse was a nonresident for the entire year and had no California source income. (Rev. & Tax. Code section 18521(c)(2).)

The applicability of this exception to the same filing status rule is, however, limited by California community property laws because marital property interest in personal property is determined under the laws of the acquiring spouse's domicile. (*Schecter v. Superior Court* (1957) 49 Cal.2d 3, 10; *Rozan v. Rozan* (1957) 49 Cal.2d 322, 326.)

Consequently, under California's community property laws, one-half of the resident spouse's salary or income may be considered to be California source income of the nonresident spouse. (*United States v. Malcolm* (1931) 282 U.S. 792; *United States v. Mitchell* (1971) 403 U.S. 190; *Appeal of Idella I. Browne*, 75-SBE-019, March 18, 1975.) If this situation exists, the couple does not meet the requirements of the exception, because the nonresident spouse has California source income.

If the couple does not meet the requirements of this exception and filed a joint federal return, a joint California return must be filed. This means that the couple must have filed separate federal returns in order to file separate California returns.

10. Changing Filing Status After A Joint Return Has Been Filed: With limited exceptions, taxpayers may not change their filing status to married filing separate after a joint return has been filed.

Generally, once married taxpayers file a joint return, they may not change their filing status after the due date for filing the return has passed. (Rev. & Tax. Code section 18521(d).) The statute provides for two exceptions to the general rule. Married taxpayers who filed a joint return may elect to file separately after the due date for filing the tax return has passed:

(1) If either spouse was an active member of the armed forces during the taxable year, or

(2) If either spouse was a nonresident for the entire taxable year and had no income from a California source (Rev. & Tax. Code section 18521(c).)

An amended return changing from married filing jointly to married filing separately must be filed within four years of the due date of the return.

The exceptions apply to tax years beginning on or after January 1, 2000. (Rev. & Tax. Code section 18521, subdivisions (c) and (d), as amended by California AB 1635 (Stats. 1999, Ch. 605).)

Both the federal and California instruction pamphlets advise taxpayers to calculate their tax liability using the married filing separately and the married filing jointly statuses to determine which method will produce the least amount of tax. Because taxpayers filing a joint return have created joint and several liability and FTB can proceed against either or both for the entire amount of a deficiency; and a change in filing status from married filing jointly to married filing separately after the due date for filing their tax return may only be made in limited circumstances, careful thought should be given the status chosen prior to filing the return. (Rev. & Tax. Code sections 18521(d), 18566 and 19006(b); *Appeal of Bennie A. Jefferson*, 79-SBE-104, June 28, 1979.)